

STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION

Charmer Water Company, Cherry Hill	)	
Water Company, Clarendon Water	)	
Company, Killarney Water Company,	)	
Ferson Creek Utilities Company and	)	
Harbor Ridge Utilities, Inc.	)	
	)	ICC Docket Nos. 11-0561 through
	)	11-0566 Consolidated
Proposed general increase in	)	
Water and Sewer rates	)	

DIRECT TESTIMONY OF MICHAEL L. BROSCHE

ON BEHALF OF

PEOPLE OF THE STATE OF ILLINOIS

DATED OCTOBER 20, 2011

DIRECT TESTIMONY OF MICHAEL L. BROSCH

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**EXHIBIT LIST**

AG Exhibit No. 1.1 Summary of Qualifications

AG Exhibit No. 1.2 Prior Testimony Listing

AG Exhibit No. 1.3 Revenue Requirement Adjustments

AG Exhibit No. 1.4 Phase-in Plan Illustration

AG Exhibit No. 1.5 Response to Data Request AG 2.3

AG Exhibit No. 1.6 Response to Data Request AG 2.6

AG Exhibit Nos. 1.7 Response to Data Request Nos. AG 2.25 and AG 2.26

**I. INTRODUCTION / SUMMARY**

1 **Q. Please state your name and business address.**

2 A. My name is Michael L. Brosch. My business address is PO Box 481934, Kansas  
3 City, Missouri 64148-1934.

4  
5 **Q. By whom are you employed and in what capacity?**

6 A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in  
7 utility rate and regulation work. The firm's business and my responsibilities are  
8 related to regulatory projects for utility regulation clients. These services include  
9 rate case reviews, cost of service analyses, jurisdictional and class cost allocations,  
10 financial studies, rate design analyses, utility reorganization analyses and focused  
11 investigations related to utility operations and ratemaking issues.

12 **Q. On whose behalf are you appearing in this proceeding?**

13 A. I am appearing on behalf of the People of the State of Illinois represented by the  
14 Attorney General, (“Attorney General” or “AG”) in order to review and respond to  
15 the overall revenue increases and certain ratemaking proposals raised by the six  
16 Utilities, Inc. (“UI”) companies; Charmer Water Company, Cherry Hill Water  
17 Company, Clarendon Water Company, Killarney Water Company, Ferson Creek  
18 Utilities Company and Harbor Ridge Utilities, Inc. (collectively, the “Companies”)  
19 that have filed for increases in water and sewer service rates and revenues. My  
20 testimony and AG Exhibit 1.3 summarizes certain recommended revisions to the  
21 overall revenue requirement asserted by the Companies, based upon certain  
22 conclusions and adjustments that I sponsor, as more fully described herein.

**Q. Will you summarize your educational background and professional experience in the field of utility regulation?**

A. AG Exhibit No. 1.1 is a summary of my education and professional qualifications. I have testified before utility regulatory agencies in Arizona, Arkansas, California, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, New Mexico, Ohio, Oklahoma, Texas, Utah, Washington, and Wisconsin in regulatory proceedings involving electric, gas, telephone, water, sewer, transit, and steam utilities. In Illinois, I have testified in several major proceedings before the Illinois Commerce Commission (“the Commission”). These include Peoples Gas rate cases in Docket Nos. 90-0007 and 07-0241, North Shore Gas Company Docket No. 92-0242, Illinois Bell Telephone Company in Docket Nos. 92-0448 and 92-0239, Commonwealth Edison Docket Nos. 07-0566 and 10-0467 and Ameren Illinois Utilities Docket Nos. 07-0585 through 07-0590. I also testified in ComEd Docket No. 09-0263 involving the Advanced Metering Infrastructure Pilot Program and Associated Tariffs and in Docket No. 10-0527 regarding a proposal for alternative regulation.

**Q. Have you previously participated in energy utility regulatory proceedings in other states?**

A. Yes. I have participated in many electric and gas regulatory proceedings, as listed and described in AG Exhibit No. 1.2.

**Q. What is the purpose of your testimony in this docket?**

A. My testimony first discusses the extraordinarily large rate increases being proposed by the Companies, and then explains and quantifies certain AG ratemaking adjustments that are necessary to reasonably quantify and moderate the test year

revenue requirement for each of the Companies. These adjustments appear in AG Exhibit 1.3, which summarizes the operating income and rate base impact of each adjustment that I recommend. It should be noted that the Attorney General's office has not attempted to replicate the rate case audit being undertaken by the Commission Staff, but rather has focused upon the selected issues presented in this testimony. Therefore, the AG adjustments should be treated as supplemental to any issues that are addressed in Staff's testimony.

**Q. Please summarize the recommendations that are set forth in your testimony and in AG Exhibit 1.3.**

A. Based upon my proposed adjustments, I recommend that the Commission reduce the Companies' proposed revenue increases to incorporate the adjustment amounts shown in AG Exhibit 1.3, along with any adjustments of Commission Staff and other parties. I also recommend implementation of a rate change phase-in plan that is described in the next section of this testimony, as illustrated in AG Exhibit 1.4.

**Q. Why should the Attorney General adjustments you propose be combined with the work of Commission Staff?**

A. As noted previously, the Attorney General did not attempt to address every issue in this proceeding. Therefore the Commission is urged to utilize the recommendations set forth in AG Exhibit 1.3 cumulatively with any appropriate ratemaking adjustments that may be sponsored by Staff or other witnesses. The rate change moderation adjustment I recommend, as set forth on AG Exhibit 1.4, should be recalibrated proportionately for any Staff-proposed ratemaking adjustments that are approved by the Commission and that have the effect of sufficiently moderating the overall level of rate increase implemented for each Company.

**Q. How are the AG revenue requirement accounting schedules within AG Exhibit 1.3 organized?**

A. AG Exhibit 1.3 is a summary of the adjusted test year Operating Income and Rate Base amounts proposed by the Companies, at Present Rate levels (before any rate increases). The amounts for Operating Income in column A of AG Exhibit 1.3 are taken directly from Schedule B in each of the Companies' filings, at column D "As Adjusted". Similarly, the single amount shown for "Rate Base" for each Company on AG Exhibit 1.3 is taken from Schedule C in each of the Companies' filings, at column D. To the right of column A, I have posted the AG proposed ratemaking adjustments for each Company. No revised total are presented on AG Exhibit 1.3 because, as noted above, these adjustments should be combined with any appropriate adjustments that are presented by Commission Staff or other intervenors. Additionally, I have not calculated revisions to income tax expenses associated with the Attorney General adjustments because overall income tax expense will need to be recalculated after all adjustments have been compiled in the Commission's Order.

## **II. RATE INCREASES / PHASE-IN RECOMMENDATION.**

**Q. Please summarize the revenue changes that are proposed by the Companies?**

A. The UI Companies have proposed very large percentage revenue changes in these consolidated Dockets. Across the six companies, two of which are proposing both water and sewer rate increases, the size of proposed revenue increases will be shocking to ratepayers. The smallest proposed rate change would increase annual Ferson Creek sewer revenues by about 91 percent, raising the average residential

ratepayer's bill from \$29.50 to \$56.43 per month. At the other extreme, the annual revenues provided by ratepayers of Charmar Water Company are proposed to be increased by 440 percent annually. The present and proposed revenue levels and percentage increases in revenues can be summarized as follows:

Table 1:

**Utilities, Inc. Proposed Revenue Increases**

Operating Company	Present Revenue	Proposed Revenue	Revenue Increase	Percent Increase
Charmar Water	\$ 24,545	\$ 132,560	\$ 108,015	440%
Cherry Hill Water	\$ 85,224	\$ 194,034	\$ 108,810	128%
Clarendon Water	\$ 93,770	\$ 249,869	\$ 156,099	166%
Killarney Water	\$ 64,455	\$ 222,403	\$ 157,948	245%
Ferson Creek Water	\$ 97,438	\$ 195,009	\$ 97,571	100%
Ferson Creek Sewer	\$ 131,076	\$ 249,767	\$ 118,691	91%
Harbor Ridge Water	\$ 74,892	\$ 151,223	\$ 76,331	102%
Harbor Ridge Sewer	\$ 30,830	\$ 72,441	\$ 41,611	135%
<b>Total Amounts</b>	<b>\$ 602,230</b>	<b>\$ 1,467,306</b>	<b>\$ 865,076</b>	<b>144%</b>

Source: UI Schedule B

**Q. Under the Companies' proposed rate design, how are residential customers' monthly bills impacted by the proposed revenue increases?**

**A.** Residential average monthly bills would be dramatically impacted, as summarized in the following table, if the Companies' proposed level of rates is approved:

Table 2:

**Utilities, Inc. Typical Residential Bill Increases**

Operating Company	Present Avg. Res. Bill	Proposed Avg. Res. Bill	Bill Increase	Percent Increase
Charmar Water	\$ 61.95	\$ 237.54	\$ 175.59	283%
Cherry Hill Water	\$ 26.42	\$ 60.34	\$ 33.92	128%
Clarendon Water	\$ 24.98	\$ 63.89	\$ 38.91	156%
Killarney Water	\$ 15.48	\$ 53.95	\$ 38.47	249%
Ferson Creek Water	\$ 21.44	\$ 42.91	\$ 21.47	100%
Ferson Creek Sewer	\$ 29.50	\$ 56.43	\$ 26.93	91%
Harbor Ridge Water	\$ 19.06	\$ 40.09	\$ 21.03	110%
Harbor Ridge Sewer	\$ 19.62	\$ 29.52	\$ 9.90	50%

Source: UI Notice to Customers

111

112 A genuine concern over rate “shock” must be considered by the Commission in  
113 connection with the Utilities, Inc. proposed annual revenue changes in these  
114 Dockets.

115 **Q. What is rate shock?**

116 A. Rate shock refers to the impact on ratepayers of abrupt and large changes in what  
117 are normally considered recurring monthly charges for essential utility services.  
118 Large increases in monthly bills for water or sewer utility service can cause extreme  
119 hardship for utility consumers, particularly those limited incomes. Water and sewer  
120 ratepayers who are accustomed to charges of \$15 to \$30 per month for utility  
121 services would experience significant pressure upon household budgets if the  
122 Companies’ proposed rate changes are approved. Low income customers would  
123 have even less ability to pay dramatically higher proposed utility bills. The “shock”  
124 of disruptively large increases in recurring monthly utility charges is generally  
125 avoided by regulators whenever possible in order to ensure public acceptance of the  
126 rates that are approved for utility services. Rate shock is not frequently an issue for



public utilities and their regulators because of the maturity and capital intensive nature of the business, where large amounts of embedded capital and a relatively stable workforce represent the majority of incurred costs and such amounts do not fluctuate dramatically from year to year.

**Q. Will the proposed rate changes in the UI filings cause rate shock?**

A. Yes. Most of the proposed UI rate increases involve more than doubling the size of ratepayers' monthly bills. Even after reducing the proposed increases for the ratemaking adjustments that are clearly needed, the expected size of the remaining rate changes is quite large. In this era of modest annual inflation and a struggling economy, revenue increases of the magnitude being proposed by the UI Companies are highly unusual.

**Q. Has Utilities Inc. explained why its proposed rate changes are so large?**

A. Not completely. The Companies' testimony is very limited in explaining its approach to determination of the overall revenue requirement for each utility and is devoid of any explanation for the shockingly large revenue changes that are proposed. The Companies' witnesses make general reference to multiple years of "rising costs" since the prior rate case of each Company and then refer generically to how, "[t]he age of the system is a factor in the cost of maintenance" and that the parent company, Utilities, Inc. "recently spent significant capital to replace their aged accounting and customer, care and billing systems, which the Company refers to as Project Phoenix."<sup>1</sup>

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<sup>1</sup> See Direct Testimonies of Dmitry Neyzelman and Lena Georgiev, on behalf of each Company, generally at pages 3 and 5 through 9.

148                   When pressed for more specific information as to why the Companies did  
149                   not previously file for rate changes, in response to Data Request AG 2.3, the  
150                   Companies claimed “The propose[d] percentage revenue increase does not greatly  
151                   exceed recent levels of inflation” and then noted that “it is costly to file a rate case”  
152                   with additional discussion of “some of the main reasons why each Company has  
153                   filed a rate case.” A copy of this Data Request Response is provided in AG Exhibit  
154                   1.5.

155   **Q.       Do you agree with the Company that, “The proposed percentage revenue**  
156                   **increase does not greatly exceed recent levels of inflation”?**

157   A.       No. The revenue changes and average bill increases being proposed by the  
158                   Companies at this time are shockingly large in relation to recent level of inflation.  
159                   Recent measures of inflation have not exceeded four percent annually in several  
160                   years.<sup>2</sup> My Tables 1 and 2 that are presented above show the Companies’ proposed  
161                   revenue and rate changes to be much higher than recent inflation levels.

162   **Q.       What is the purpose of your testimony on the subject of rate shock?**

163   A.       I am proposing a series of ratemaking adjustments that, when combined with the  
164                   recommendations of Commission Staff, may still produce unacceptably large rate  
165                   shock impacts upon consumers. My testimony on rate shock is to provide an  
166                   alternative rate change approach for Commission consideration if the combined  
167                   impact of my proposed ratemaking adjustments and those proposed by Staff are

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<sup>2</sup>       Widely accepted measures of retail and wholesale price levels changes include the Consumer Price Index, the Producer Price Index and the Gross Domestic Product Price Index. These data are available at: <http://data.bls.gov/cgi-bin/surveymost?cu> and <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>

insufficient to acceptably moderate the shockingly large rate changes being  
proposed by the UI Companies.

**Q. When the Commission establishes utility rates, under its statutory authority, is there any requirement to consider the overall equity and fairness of the rates that are established?**

A. I am not an attorney and cannot offer any legal opinion, but am advised by AG counsel that the General Assembly expects the Commission to approve rates that achieve certain overarching purposes:

(220 ILCS 5/1-102) (from Ch. 111 2/3, par. 1-102)

Sec. 1-102. Findings and Intent. The General Assembly finds that the health, welfare and prosperity of all Illinois citizens require the provision of adequate, efficient, reliable, environmentally safe and least-cost public utility services at prices which accurately reflect the long-term cost of such services and which are equitable to all citizens. It is therefore declared to be the policy of the State that public utilities shall continue to be regulated effectively and comprehensively. It is further declared that the goals and objectives of such regulation shall be to ensure...".

Then, among the listed goals and objectives is the following:

(d) Equity: the fair treatment of consumers and investors in order that

- (i) the public health, safety and welfare shall be protected;
- (ii) the application of the rates is based on public understandability and acceptance of the reasonableness of the rate structure and level;

- 191 (iii) the cost of supplying public utility services is allocated to those  
192 who cause the costs to be incurred;
- 193 (iv) if factors other than cost of service are considered in regulatory  
194 decisions, the rationale for these actions is set forth;
- 195 (v) regulation allows for orderly transition periods to accommodate  
196 changes in public utility service markets;
- 197 (vi) regulation does not result in undue or sustained adverse impact on  
198 utility earnings;
- 199 (vii) the impacts of regulatory actions on all sectors of the State are  
200 carefully weighed;
- 201 (viii) the rate for utility services are affordable and therefore preserve the  
202 availability of such services to all citizens.

203 This section of my testimony regarding rate shock is offered out of concern with the  
204 “public understandability and acceptance” of UI’s proposed rate change that double  
205 and in some instances nearly quadruple existing monthly charges to ratepayers. The  
206 proposed rates raise serious concerns regarding affordability and the preservation of  
207 availability of services to all ratepayers of these UI water and sewer utilities. The  
208 suddenness and size of the proposed rate increases undermines this generally  
209 accepted ratemaking principle.

210 **Q. Has the Commission previously approved a rate moderation plan to deal with**  
211 **rate shock considerations?**

212 A. Yes. In Docket No. 06-0411, Commonwealth Edison (“ComEd”) filed a Petition  
213 for approval of tariffs implementing its proposed Residential Rate Stabilization  
214 Program (“RRS Program”), which was designed to phase in, over a three year

period, the large rate increase occurring after the end of the mandatory transition period to market-based rates. Under the proposed ComEd program, customers would see an increase in the average annual residential rates per kilowatt-hour that would be capped at 10 percent per year in each of the years 2007, 2008 and 2009 (the “rate caps”). The Commission’s Order dated December 20, 2006 approved the ComEd RRS Program in order to “make the transition to higher rates less drastic and sudden,” but limited the carrying charges allowed the utility to a 3.25 percent annual rate that was explained as follows:

After all, the shareholders, just like ratepayers, have a very strong interest in the success of a smooth transition from frozen rates to market based rates. ComEd’s ratepayers deserve the option to make the transition to higher rates less drastic and sudden and they deserve to do so on terms that are reasonable and fair to them. A zero interest rate for deferrals would certainly achieve that goal but in our opinion such scheme would inappropriately shift too much of the burden to the shareholders. We feel that the midpoint between zero and ComEd’s proposed 6.5% is fair to both shareholders and ratepayers. The Commission believes that a 3.25% rate for deferrals makes the RRS Program a very attractive option for residential customers who will be challenged with an appreciable increase in their electric bills.<sup>3</sup>

**Q. What have regulators done in other jurisdictions to combat rate shock?**

A. Regulators in other jurisdictions have also required moderation in the size of immediate rate changes to reduce the potential for rate shock. Rate increase “phase-in plans” were relatively common in the 1980’s when large electric utility investments in nuclear and other base-load generating units were included in utility rate base, causing abrupt revenue requirement growth at levels not acceptable to ratepayers.

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<sup>3</sup> Commonwealth Edison Company Petition for approval of tariffs implementing ComEd’s proposed residential rate stabilization program, Order dated December 20, 2006 in Docket No.06-0641, p21.

244 **Q. Are phase-in plans consistent with any general regulatory policies that are**  
245 **routinely employed as part of the rate setting process?**

246 A. Yes. Rate design changes are typically designed with the concept of “gradualism”  
247 in mind, so that any dramatically large changes in rates are implemented in stages  
248 over an extended period of time, allowing ratepayers to adapt to the changes and  
249 make changes in their consumption patterns and/or monthly budgets as necessary.  
250 Gradualism is also beneficial to the utility by reducing the frequency and intensity  
251 of customer complaints, moderating the exposure to uncollectible accounts, and  
252 minimizing the risk of future revenue instability if customers respond to large rate  
253 increases by significantly reducing demand for utility services after new rates are  
254 set.

255 **Q. Are you proposing a rate change phase-in plan for the UI utilities at this time?**

256 A. Yes. In the event the cumulative impact of ratemaking adjustments proposed by the  
257 Staff and AG that are approved by the Commission are insufficient to avoid rate  
258 shock to UI ratepayers, I proposed that the ultimately approved rate changes be  
259 limited to an immediate, and then subsequent annual installment increases, that do  
260 not increase average residential monthly bills by more than \$10 per month or 20  
261 percent per year, whichever is higher. Approved tariffs should be filed with  
262 sequenced effective dates that meet the ultimately approved revenue requirement,  
263 by implementing phased-in annual increases limited by these constraints.

264 **Q. Can you provide an example of how this rate moderation plan would work for**  
265 **Charmar Water customers, where the proposed revenue increase is the**  
266 **largest?**

267 A. Yes. The largest percentage revenue and average bill increase is proposed for the  
268 Charmar Water Customers. According to the Public Notice to Charmar Customers,  
269 assuming an average water residential monthly consumption of 3,500 gallons, the  
270 monthly charge for residential water service will increase from \$61.95 to \$237.54 at  
271 Company-proposed rate levels. The AG's recommended rate moderation plan  
272 would limit the initial, and subsequent annual rate changes, to the lesser of \$10.00  
273 or 20% higher monthly bills relative to presently effective rates.

274 Using these limits, if assume that the Commission, after considering all the  
275 evidence in this case, concludes that Charmar's approved revenue requirement  
276 would result in average monthly residential bills of \$120.00, the phase-in limited  
277 first year average monthly bill would be \$74.24 per customer (120% of \$61.95).<sup>4</sup>  
278 At the start of year two, rates would be adjusted upward to produce an average  
279 residential monthly bill (at 3,500 gallons) of \$89.21. At the beginning of year three,  
280 Charmar's rates would again be adjusted to produce an average residential customer  
281 bill of \$107.05 (120% of \$89.21) and in year four, the entire ordered revenue  
282 requirement of \$120 per average customer could be effective because the limitation  
283 by that time (\$128.46, which is 120% of \$107.05) is no longer applicable.

284 **Q. Should the revenue increases and bill impacts for UI commercial customers**  
285 **also be phased in using a plan comparable to your recommendation for**  
286 **residential customers?**

287 A. Yes. Schedules D and E submitted by each of the UI Companies illustrates the  
288 contribution of residential and commercial customers' billing volumes to the annual

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<sup>4</sup> Throughout this discussion, the reference to customer bills is intended to constrain the underlying tariff rate levels to achieve the average bill at average monthly usage levels.

revenues of each utility and present and proposed rate levels, respectively. It is clear from a review of these schedules that the majority of billed volumes and annual revenues are derived from serving residential customers. Therefore, imposition of a comparable phase-in limitation for Commercial customers based upon average bill limitations would not represent any financial hardship for the utilities and would also provide meaningful monthly bill stabilization for the UI non-residential customers.

**Q. Would it be appropriate to allow the deferral of carrying charges on the revenues that are deferred under your proposed phase-in plan?**

A. Carrying charges should be awarded on a conditional basis. I recommend that the Commission hold UI accountable for a full and complete explanation of the reasons why its costs have grown so significantly since each utility's existing rate levels were last established. If this explanation by management is credible and management has demonstrated that its actions were prudent and that it has effectively controlled costs, a phase-in plan should be ordered. The phase-in plan could provide for a modest carrying charge rate tied to the Company's cost of short term debt used to finance such deferrals, applied to the after-income-tax balance of cumulative revenue deferrals during the phase-in period. The Attorney General is willing to work cooperatively with the Staff and UI Companies to refine the specific terms of the appropriate phase-in plan and tariffs.



**III. GENERAL INFLATION ASSUMPTION**

**Q. Have the Companies applied any generalized adjustment factor to its test year Maintenance and General Expenses, to account for assumed inflation that may occur after the test year in developing its asserted revenue requirement?**

A. Yes. According to footnote (j) explaining each of the Companies' Schedule B Income Statement adjustments, "A consumer price index increase of ..... has been included in this filing." The Companies' workpapers<sup>5</sup> indicate that the derivation of this assumed CPI increase percentage is a long term average of inflation over the years since the Company's last rate case. The expenses that are "inflated" by this factor include most of the test year recorded non-labor expenses that are not separately annualized.

**Q. What is the purpose of the AG Adjustment No. 1 appearing in column B of AG Exhibit 1.3?**

A. AG Adjustment No. 1 eliminates the Companies' unsupported escalation of test year non-labor expenses based on a historical average CPI factor.

**Q. Why should the Companies' proposed CPI inflation adjustment not be accepted?**

A. There are a number of reasons why the Utilities, Inc. inflation index adjustments are inappropriate and should be rejected, including:

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<sup>5</sup> Revenue requirement calculation "template" Excel files were provided in response to Staff Data Request No. DLH-01. These files were designated confidential and are only generally described in this testimony and in AG Exhibit 1.3.

- The Companies have provided no studies or workpapers demonstrating that long-term CPI changes are directly correlated to changes in non-labor Company expenses that have been occurring after the test year.
- CPI is computed based upon a market basket of “consumer” goods and services, rather than the types of goods and services that are typically purchased to provide utility services. For example, CPI contains a significant weighting of price level changes for housing, food, apparel, recreation and medical services, none of which are significant elements of the expenses to which the Companies have applied the CPI index.<sup>6</sup>
- CPI levels are not the only drivers of changes in non-labor expenses, yet the subject expenses in the Companies’ filings are adjusted for only inflation.
- Utility management should be constantly searching for improved methods of operation and opportunities for automation that improve productivity, as an offset to inflationary pressures, yet no productivity offset is utilized by the Companies in connection with the CPI inflation adjustment.
- CPI levels have declined in recent months, such that a lower CPI factor than was used by the Companies would be more indicative of the last 12 months change in CPI, when computed without more volatile changes in prices for food and energy.<sup>7</sup>

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<sup>6</sup> See Table 1 published by the Bureau of Labor Statistics, available at: <http://www.bls.gov/cpi/cpid1108.pdf>

<sup>7</sup> The index for all items less food and energy has risen 2.0 percent in the last 12 months. This 12-month change has been trending up since reaching a low of 0.6 percent for the 12 months ending October 2010. See: <http://www.bls.gov/cpi/cpid1108.pdf> at page 2.

- The Companies' CPI factor adjustments are inappropriate piecemeal ratemaking adjustments that seek to project costs a full year beyond test year-end, even though there has been no corresponding updating of accumulated depreciation or accumulated deferred income taxes for the year after test year-end.

Selective adjustments for anticipated increasing costs should be offset by favorable changes in costs in order to maintain appropriate test year matching. The Companies' application of a general inflation adjustment reaching a full year beyond the mid-point of the test year, with no attempted accounting for other cost changes occurring during this period, creates an unacceptable mismatch among the elements of the revenue requirement.

**Q. Has each Company consistently employed the same CPI inflation factor in projecting non-labor expense increases that may occur after test year-end?**

A. No. The CPI factors used vary from a low of 4.41 percent used to calculate the Harbor Ridge expenses to a high of 5.95 percent used in the Charmar filing.<sup>8</sup>

**Q. Is there any basis to assume that different CPI inflation rates would apply to the various Utilities, Inc. water and sewer operations since the test year?**

A. No. Any inflationary pressures are likely to be fairly uniform upon the Utilities, Inc. operating companies, since most of their business is centralized and conducted under management and automated systems of the Water Service Corporation. As noted above, it is reasonable to expect that some productivity gains can be achieved by the Companies as an offset to the recently modest levels of price level inflation that have been experienced.

**IV. CASH WORKING CAPITAL**

**Q. What amount of Cash Working Capital is proposed for rate base inclusion by the Utilities, Inc. Companies in this Docket?**

A. The Companies have requested an allowance for Cash Working Capital (“CWC”) based upon an obsolete and unsupported 45-day formula allowance. For example, the Harbor Ridge Cash Water Working Capital allowance of \$8,973 at Schedule C, page 2, line 6, in column D is the product of total Maintenance, General and Other Taxes expenses of \$71,786 times 45/360 days.

**Q. Have the Utilities, Inc. Companies undertaken any studies or produced any evidence to support their proposed Cash Working Capital allowance?**

A. No. This question was asked in Data Request No. AG 2.6 and the Companies’ response to this question stated, “No such studies have been performed.” A copy of this response is included as AG Exhibit 1.6.

**Q. What is the underlying basis for the 45-day formula to estimate Cash Working Capital?**

A. The 45-day formula is based upon an incorrect general assumption that it takes the utility 45 days longer to collect its revenues than it can effectively delay paying its expenses. This so-called 1/8<sup>th</sup> of expenses or 45-day formula is believed to have been first applied in a 1929 Interstate Power rate case before the Federal Power Commission based upon that utility’s circumstances at that time, and has continued to be used and abused in the regulation of mostly small utilities who are not

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<sup>8</sup> See Schedule B, page 4 at footnote (j) for each Company.

interested in investing the resources required to actually measure and quantify Cash Working Capital that should be included in rate base.

Under the 45-day formula, there are no studies or even thoughtful assumptions applied to Company-specific data to see if an assumed 45 day net delay in operating cash flow is reasonable. With any thoughtful consideration, the 45-day formula can be observed to significantly overstate actual Cash Working Capital. For example, with monthly billing and average customer remittances within 30 days of billing month-end, the overall cash revenue lag might be approximately 45 days; including one-half of the billing month which is about 15 days, plus another 30 days waiting for customer remittances. In this example, the cash working capital based on 45 days could theoretically apply, but only if the utility paid its employees and vendors instantly on every day they provide labor, services and materials to the utility, causing there to be no delay in the outflow of cash to fund operating expenses. We know, however, that vendors and employees are not paid immediately at the end of each day. We also know that payroll taxes and income taxes are payable only after the pay periods and subject to statutory dates that yield considerable cash flow retention by the utility.

**Q. Is it possible to conduct a documented study of the timing of cash flows in order to measure the utility's CWC requirements?**

A. Yes. A Lead/Lag study is an analysis of the timing of cash flows through the utility, aimed at determining whether the utility collects cash revenues from its customers more rapidly or less rapidly than it pays its employees and vendors for the input resources required to provide utility services. As an extremely simplified

example, if the utility had only a single output (water) and a single input (purchased water), and if the utility could collect its revenues within 30 days of providing service and delay paying for purchased water for the same 30 days, it would have a working capital requirement of zero because its accounts receivable would remain nearly equal to its accounts payable at all times. Of course, a real utility may have only a single output (water), but typically has many input resource costs that are incurred to provide service, including employee labor, employee benefits, purchased materials, taxes and interest expense. The Lead/Lag study is conducted to systematically measure the number of days it takes, on average, for the utility to bill and collect its revenues compared to the time in days the utility is able to delay payment of its expenses. However, for small water and sewer utilities, it is often more expensive to conduct a lead lag study than is justified by the value of the rate base allowance that results, particularly if the study produced a small or negative cash working capital value.

**Q. Is it a certainty that a utility's CWC is always a positive amount that should be included in rate base?**

A. No. A properly prepared Lead/Lag study that fully considers the timing of all cash expenses will often return a negative or nearly zero CWC result, because of the extended periods over which utilities are allowed to pay certain taxes and interest expenses.

**Q. Is it possible that the 45 day allowance yields a reasonable estimate of Cash Working Capital for the Utilities, Inc. Companies?**

443 A. No. Now that the Companies are moving toward monthly billing for their services,  
444 the 45-day allowance for Cash Working Capital is almost certain to overstate the  
445 actual Cash Working Capital that is needed to operate these Companies. Even if an  
446 assumption of 45 days is reasonable for the collection of revenues (the revenue lag),  
447 we know with certainty that the Companies do not instantly make daily payments to  
448 employees and vendors in connection with all operational expenses.

449 **Q. Are the Companies able to delay the cash payments associated with labor**  
450 **costs?**

451 A. Yes. Bi-weekly and semi-monthly pay periods are practiced for Utilities Inc.  
452 personnel, with pay day occurring after the end of the pay period.<sup>9</sup> This fact  
453 demonstrates that the 45-day allowance is unreasonable for these Companies with  
454 regard to timing of cash flows related to recovery and payment of labor expenses.

455 **Q. Are the Companies able to delay the cash payments associated with vendors**  
456 **that provide goods and services that end up within test year expenses?**

457 A. Yes. Payments of invoices occur according to the terms of each vendor and credit  
458 card bills are paid online, so that no late charges are incurred. All utility invoices  
459 are paid upon receipt so that there are no late fees or interest charges.<sup>10</sup>

460 **Q. What is your recommendation regarding the amount of CWC that should be**  
461 **included in ComEd's rate base at this time?**

462 A. I recommend a zero allowance for CWC at this time. The Companies have not  
463 presented any reliable study to support an amount for CWC that should be included

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<sup>9</sup> UI Companies' response to Data Request AG 2.8.

<sup>10</sup> UI Companies' response to Data Request AG 2.9.

in rate base. Moreover, the Companies maintain a centralized cash management system where customer deposit accounts are swept into a single depository account and all checks are written from a single disbursement account.<sup>11</sup> Clearly the Companies are actively managing cash working capital so as to minimize any investment in working capital needed to operate these utilities. It would be unreasonable to overstate rate base by assuming mismanagement of cash working capital in the magnitude implicitly assumed by use of the obsolete and unproven 45-day formula approach.

**Q. What is the purpose of AG Accounting Adjustment No. 2 appearing in AG Exhibit 1.3?**

A. AG Adjustment No. 2 eliminates the CWC allowance proposed by Utilities, Inc. so as to include a zero allowance in rate base.

## **V. RATE CASE LABOR EXPENSES**

**Q. What is proposed by the Companies with regard to rate case expenses?**

A. The UI Companies have proposed that a three year recovery of estimated rate case expenses be included in the revenue requirement for each of the Companies. The costs proposed for such deferral and recovery include estimated legal, travel and consulting fees as well as estimated allocations of the labor costs for certain Water Service Corporation employees, based upon the hours they intend to spend on each Company's rate case.

**Q. Is the Company's proposed treatment of rate case expenses unusual?**

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<sup>11</sup> UI Companies' response to Data Request AG 2.10.



487 A. Yes. The inclusion of labor costs for Company employees is unusual and creates a  
488 problem of over-recovery of labor costs if approved by the Commission. The  
489 typical recovery of rate case expenses is limited to non-labor costs because of these  
490 problems.

491 **Q. Why is the inclusion of employee labor hours and costs within estimated rate**  
492 **case expenses problematic?**

493 A. The full cost of UI employees, as allocated to each of the operating utilities, has  
494 been included in the determination of test year expenses. This is confirmed in the  
495 UI response to Data Request AG 2.21: “Yes, the asserted test year operating  
496 expenses for each case include a full year’s annualized and allocated salary and  
497 benefits.” When some of the labor hours and costs for the same employees is  
498 assumed to be deferred and recovered over three years as part of estimated rate case  
499 expense, the Companies will over-recover total labor costs – collecting such costs  
500 once through operating expenses and again through rate case expense recoveries.  
501 This is why utility labor hours and costs are not reasonably included as part of  
502 recoverable rate case expenses.

503 Public utilities do not generally hire incremental employees to conduct a  
504 rate case, so labor expenses should not be accounted for as part of rate case  
505 expenses that are separately allowed as rate case expenses in determining the  
506 revenue requirement. Specific accounting and recovery processes are only  
507 necessary where discretely significant incremental costs are incurred to conduct a  
508 rate case, because such costs would be difficult to normalize for the test year  
509 without such specific identification and accounting.

510 **Q. What would be required to properly synchronize the Companies' test year**  
511 **payroll expense calculations with rate case expense accounting?**

512 A. The test year distribution of annualized employee labor costs would need to  
513 "match" the labor hours and costs being capitalized in the test year with the  
514 amounts of labor hours and costs being treated as rate case expense. The labor  
515 hours treated as separately recoverable for rate case support would need to be  
516 subtracted from total labor hours and costs included in test year expenses.

517 **Q. Is this necessary matching of labor cost distributions reflected in the**  
518 **Company's test year expenses?**

519 A. No. The confidential workpapers provided in support of capitalized labor costs for  
520 each Company indicate a much lower amount of Water Service Corporation  
521 Capitalized Time than is included within the Companies' asserted rate case  
522 expenses. In total, less than \$10,000 of such WSC capitalized time is attributed to  
523 the UI Companies in the test year as a reduction to expenses. However, more than  
524 \$140,000 of test year labor costs is treated as separately recoverable through rate  
525 case expense. These calculations will result in a significant over-recovery of total  
526 annual labor costs if not corrected by the Commission.

527 **Q. What is the purpose of the AG Adjustment No. 3, appearing in Column D of**  
528 **AG Exhibit 1.3?**

529 A. The adjustment shown in column D reduces the General Expenses proposed by the  
530 Companies to eliminate the employee labor cost component of the Companies'  
531 proposed test year rate case expense amortization. These amounts are net of the  
532 much smaller capitalized WCS labor costs already embedded in the Companies'

533 workpapers, so as to ensure that test year labor costs are not over or under-  
534 recovered, in total.

535 **Q. Are you challenging any other elements of the asserted rate case expenses?**

536 A. Not at this time. I have noted that Commission Staff is tracking and analyzing  
537 actual expenditures, relative to the Companies' estimates. I have not replicated this  
538 effort but reserve the right to comment on the rate case expense as this docket  
539 proceeds and the issues are narrowed. My proposed adjustment is intended to  
540 correct for the inappropriate inclusion of labor costs within these estimates. If  
541 appropriate, I will modify my adjustment to correspond with the rate case expense  
542 determined after analysis of the underlying charges.

543 **Q. Is it unusual, in your experience, for utilities to include their own employees'**  
544 **labor costs within rate case expenses?**

545 A. Yes. I do not recall any rate case in my experience where the utility's labor costs  
546 were treated as part of rate case expenses. For example, in the most recent  
547 Commonwealth Edison rate case proceedings, only non-labor costs were  
548 accumulated within asserted rate case expenses that would be subject to  
549 Commission review and then amortization as part of the revenue requirement.<sup>12</sup>

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551 **VI. CHARMAR ABANDONMENT LOSS.**

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553 **Q. Does any unique transaction contribute to the extremely large revenue**  
554 **requirement being asserted by the Charmar Water Company?**

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<sup>12</sup> For example, in Docket No. 10-0467, ComEd submitted Schedule C-10 in support of its asserted \$8.5 million of asserted rate case expenses, including consultants, expert witnesses and external legal fees, but no internal labor costs.

555 A. Yes. At page 12 of his Direct Testimony, Charmar witness Mr. Dmitry Neyzelman  
556 explains that the utility completed an interconnection with the City of Waukegan to  
557 commence buying its water supply, resulting in abandonment of the Charmar  
558 investment in its water treatment plant. This abandonment occurred before the  
559 entire original cost of this investment had been recovered through normal  
560 depreciation accrual procedures. Mr. Neyzelman proposes, with reference to a  
561 Florida ratemaking procedure, that the remaining un-depreciated balance in  
562 Charmar's water treatment plant be amortized over an approximate eight year  
563 period. This proposal contributes an additional \$16,405 to the Company's annual  
564 depreciation expense within the Charmar filing.

565 **Q. Does the AG object to Charmar's proposed recovery of the remaining**  
566 **unrecovered cost of the water treatment plant?**

567 A. No. However, given the adverse impact upon ratepayers caused by the very large  
568 revenue increase that is being proposed at this time, the AG recommends that the  
569 amortization period for this extraordinary retirement be lengthened to 15 years to  
570 help moderate the rate impact of the abandonment of these facilities. A reasonable  
571 sharing of the cost of this abandonment is accomplished by an extended  
572 amortization, with no rate base inclusion of the unamortized balance during this  
573 period.

574 **Q. Aside from the need for moderation of revenue requirement impacts, are these**  
575 **additional considerations that support extended amortization of these costs?**

576 A. Yes. The costs in question represent recovery of retired assets that are, by  
577 definition, no longer used and useful in the provision of utility services, causing any  
578 recovery at all to be extraordinary and beneficial to UI shareholders. In a

competitive business, the cost of abandoned facilities is generally borne by investors rather than customers of a business. Additionally, recovery of abandoned water treatment facility costs represent a duplication of supply cost recoveries from a small group of ratepayers that must also fund all of the purchased water expenses from the Waukegan supply source, while recovery would continue for the remaining costs of abandoned Charmar water treatment facilities. These considerations support the longer 15-year amortization period being proposed by the AG.

**Q. What is the purpose of the adjustment appearing at AG Exhibit 1.3, in column E?**

A. This Attorney General ratemaking adjustment reduces the Depreciation and Amortization Expense proposed by Charmar Water Company to amortize the unrecovered cost of the Company's abandoned water treatment facilities over a 15-year period, in place of the more accelerated 8-year amortization being proposed by Mr. Neyzelman.

## **VII. PRO-FORMA PROJECTS.**

**Q. Have the UI Companies proposed any pro-forma additions to rate base?**

A. Yes. Additional "Net Pro Forma Plant" is being proposed for the following entities:

- Cherry Hill Water Company                      \$180,000
- Killarney Water Company                      \$170,000
- Harbor Ridge Water Company                      \$132,000

These projects are described in the Direct Testimony of Mr. Bruce Haas and are related primarily to sandblasting and re-painting of existing water towers for these three Companies. For all three projects, Mr. Haas states, "Funding of this project has been approved by management and the completion date will occur in the fourth quarter of 2011."

**Q. Have these Companies' filings reflected proper accounting for the costs of this type of activity?**

A. No. Cleaning, restoration and painting of water towers is not a capital investment activity and the costs in question cannot be charged to Plant in Service, as shown in the Companies' filings. Instead, these are costs properly characterized as maintenance expenses associated with existing Plant in Service investments. Such tower maintenance costs are properly expensed on the Companies' books when incurred. The NARUC Uniform System of Accounts for Class A Water Companies ("Water USOA") is available on the Commission's web site<sup>13</sup> and provides that only the "first cost" of painting water supply structures can be included within Plant in Service Account 304 Structures and Improvements. Costs incurred after initial construction to restore and re-paint such assets are to be expensed on the books.

**Q. Is it possible that what the Companies intended to propose is an amortization treatment for anticipated large future maintenance expenditures for tank painting?**

A. I suspect this is the intent behind the Company's rate base adjustments, in spite of the inappropriate posting of the adjustments to the Plant in Service accounts. The proposed 10-year amortization of the estimated tank painting costs is suggestive of

a request to include a normalized level of tank painting expenses within the test year revenue requirement, as if these costs will be recurring in nature on a 10-year cycle. The aforementioned Water USOA contains provisions for such commission-authorized “deferred tank painting” as stated below:

**186. Miscellaneous Deferred Debits**

A. This account shall include all debits not elsewhere provided for, such as miscellaneous work in progress, losses on disposition of property net of income taxes, deferred by authorization of the Commission, unusual or extraordinary expenses and regulatory assets resulting from rate making actions, not included in other accounts, which are in process of amortization, and items the proper final disposition of which is uncertain.

B. The records supporting the entries to this account shall be so kept that the utility can furnish full information as to each deferred debit, including justification for inclusion of such amounts in this account.

C. The following subaccounts shall be maintained as a minimum unless otherwise authorized by the Commission. The utility may add additional subaccounts, if desired (such as deferred tank painting expense).

- 186.1 Deferred Rate Case Expense
- 186.2 Other Deferred Debits
- 186.3 Regulatory Assets

**Q. Has the Company provided any supporting historical data to justify including tank painting expenses within the revenue requirement of the three water utilities, as an addition to rate base with 10-year amortization?**

A. No. Any intended rate base treatment of a deferred extraordinary expense amount is completely unsupported. If the Companies’ intent is to include a normalized expense level for water tower re-painting, this is not explained in the Companies’ prefiled testimony.

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<sup>13</sup> See USOA Working Copies available at <http://www.icc.illinois.gov/publicutility/usoa.aspx>

657 **Q. Did the Attorney General attempt to analyze historical tower painting**  
658 **intervals and costs to determine whether any normalized allowance for water**  
659 **tower painting is justified?**

660 A. Yes. Data Requests AG 2.25 and AG 2.26 were submitted to the Companies  
661 seeking information about the historical frequency and cost of such activities, as  
662 well as any Commission decisions addressing this issue. The Companies objected  
663 to providing this information, as shown in AG Exhibit 1.7 containing copies of  
664 these data request responses.

665 **Q. Have the Companies already commenced spending on the three water tower**  
666 **projects, indicating a commitment to actually incur these costs?**

667 A. No. According to the response to Data Request AG 1.39, there have been no actual  
668 costs incurred for the pro-forma projects for Harbor Ridge or Killarney. With  
669 regard to the Cherry Hill project, documentation attached to this response indicates  
670 total spending of only \$15,317 has occurred for Preliminary Survey charges to  
671 Account 285 as of September 2011.

672 **Q. What is the purpose of AG Adjustment 5 that appears at AG Exhibit 1.3, in**  
673 **column F?**

674 A. This adjustment eliminates the pro-forma additions to Plant in Service and the  
675 related 10-year amortization expenses that are proposed for the Cherry Hill,  
676 Killarney and Harbor Ridge water utilities.

677 **Q. Why should the Companies' pro-forma project costs be eliminated, as you**  
678 **have proposed?**

679 A. These project cost amounts should be excluded for several reasons, including:



1. The estimated costs for water tower rehabilitation and re-painting represent maintenance expenses that should not be included in rate base as Plant in Service. The Companies have misclassified these expenditures as rate base investments.
2. The Companies have made no showing that test year maintenance expenses are understated or that an amortization adjustment for additional tower painting expenses is appropriate.
3. There has been no commitment to incur actual costs in the estimated amounts proposed by the Companies, making the adjustments not known and measureable. Notwithstanding the Companies' assertion that the work would be done by the fourth quarter, 2011, it has not done any significant work on these projects to date (October 20, 2011).
4. Inclusion of pro-forma estimated maintenance allowances to be incurred many months after test year-end introduces a potential distortion in the matching of test year costs. Cost reductions in other areas of the business may be available to offset some or all future tower painting expenses.
5. Utilization of a historical test year normally requires expenses be incurred on an actual basis, prior to recognition within the ratemaking process. Recognizing the Company's proposed pro-forma projects at estimated future cost levels would inject selective elements of a projected test year into an otherwise historical ratemaking approach, thereby overstating the revenue requirement.

**VIII. SUMMARY AND CONCLUSION.**

**Q. Please summarize the conclusions reached within your testimony.**

A. My Direct Testimony outlines the revenue requirement position of each of the Utilities, Inc. Companies in these consolidated dockets and explains why the proposed revenue and rate changes are unreasonable and will produce rate shock to consumers if approved by the Commission. I then describe a form of rate phase-in plan to be employed in an effort to moderate the customer impact of approved rates, with an illustration of how the plan should be applied using hypothetical approved rate levels for each utility.

My testimony also describes and sponsors several ratemaking adjustments that should be applied in calculating the revenue requirement for each Company and that will help to moderate the rate adjustments if approved by the Commission. These adjustments include elimination of the Companies' proposed general inflation adjustment, the unsupported 45-day formula cash working capital allowance and the selective pro-forma plant additions adjustments. I also correct the Companies' asserted rate case expenses to avoid double counting of labor costs and revise the amortization period for extraordinary property abandonment costs experienced by Charmar Water Company. My recommended ratemaking adjustments should be treated as additive to other adjustments that may be proposed by the Commission Staff in areas that I did not examine or address in my testimony.

**Q. Does this conclude your testimony at this time?**

A. Yes.